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Ten Years of Post-Socialist Transition Lessons for Policy Reform

Grzegorz W Kolodko

It is naive to assume that a market economy can be introduced by shock therapy A market economy requires adequate institutions and appropriate behavior both of which can be introduced only gradually because they require new organizations new laws and changes in behavior of various economic entities

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Summary findings

It is naive to believe that a market economy can be introduced by "shock therapy," Kolodko argues. In the several cases when it has been attempted, it has brought problems. A market economy requires adequate institutions and appropriate behavior, both of which can be introduced only gradually because they require new organizations, new laws, and changes in behavior of various economic entities.

In 1989 influential financial organizations, political bodies, and professional economists seemed to agree — the so-called Washington consensus — on the main points of economic policy reform. Although the economic policies underlying that consensus were developed with no concern for post-socialist transformation, they have significantly influenced economic thought and action in Eastern Europe and the countries of the former Soviet Union.

And because those policies were not designed for the overhaul of post-socialist economies, they have failed, especially since they have not yet brought sustainable growth.

A new post–Washington consensus is developing, based on lessons from experience so far. Post-socialist occurrences are also contributing to development policy reorientation. Among realities policymakers must recognize:

- Above all, appropriate institutional arrangements are needed for growth.
- Institution-building by its very nature must be gradual.
- The size of government is less important than the quality of government policy and how the government changes.
- If the formation of institutions is left to spontaneous forces unleashed by liberalized markets, the vacuum will be filled by informal institutions.
- The judiciary system must be transformed to serve the market economy.
- Deregulating the post-socialist economy requires shifting competence and power from central to local governments.
- The development of nongovernmental organizations must be accelerated.
- Government concern about equitable growth and income policy is important during the transition.
- With the support of international financial institutions, countries must monitor and control short-term capital liberalization.
- The Bretton Woods organizations should reconsider their policies toward transition economies — and should especially provide more support for institution-building and equitable growth.

This paper — a product of Macroeconomics and Growth, Development Research Group — is part of a larger effort in the group to study the policy reforms for sustainable development and the role of institutional arrangements in managing transition to a market economy. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Jennifer Prochnow-Walker, room MC3-378, telephone 202-473-7466, fax 202-522-1152, Internet address jprochnow@worldbank.org. Policy Research Working Papers are also posted on the Web at http://www.worldbank.org/html/dec/Publications/Workpapers/home.html. The author may be contacted at gkolodko @imf.org. April 1999. (29 pages)

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Ten Years of Post-Socialist Transition Lessons for Policy Reform

by

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The author was Poland's First Deputy Premier and Minister of Finance since 1994 to 1997. This paper, based on his own economic policy experience and comparative studies, has been written when he was Senior Visiting Scholar at the Economic Policy Department of the World Bank in 1998. The author wishes to express his appreciation for critical comments he has received on the earlier versions of the paper to James Wolfensohn, Joseph Stiglitz, Johannes Linn, David Dollar and Richard Hirschler. He is especially indebted to Marcelo Selowsky for his criticism and advice.

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Ten Years of Postsocialist Transition: the Lessons for Policy Reforms

1. Introduction

The centrally planned economy has ceased to exist. Even in countries still considered socialist (communist), as China and Vietnam, the mechanism of economic coordination has shifted to a great extent from state intervention to market allocation. Thus, during the 1990s the process of postsocialist transformation has advanced significantly. About 30 countries in Eastern Europe, the former Soviet Union and Asia are involved in vast systemic changes. Undoubtedly, these changes are leading to full-fledged market economies, though the precise outcome of transformation is not going to be the same for all countries involved. Whereas some, leaders in transition and well-placed geopolitically, are bound to join the European Union in the foreseeable future, others, lagging behind in systemic changes, will remain hybrid systems with the remnants of central planning alongside elements of market regulation and a growing private sector. Whereas some countries will expand quickly and catch up with their developed neighbors within a generation, others will experience sluggish economic growth and a relatively low standard of living.

Transition to a market economy is a lengthy process comprised of various spheres of economic activities. New institutional arrangements are of key importance for successful transformation. A market economy requires not only liberal regulation and private ownership, but also adequate institutions. For this reason transition can be executed only in a gradual manner, since institution building is a gradual process based upon new organizations, new laws, and the changing behavior of various economic entities. The belief that a market economy can be introduced by "shock therapy" has been wrong, and in several cases, when attempted, has caused more problems than it has solved. Only liberalization and stabilization measures can be introduced in a radical manner, and even this is not a necessity. The need for such method depends on the scope of financial destabilization and is only possible under certain political conditions.

The main argument in favor of transition was a desire to put the countries in question on the path of sustainable growth. It was assumed that the shift of property rights from state to private hands and the shift of allocation mechanism from state to free market would soon enhance saving rates and capital formation, as well as allocative efficiency. Thus it ought also to have contributed to high-quality growth. Unfortunately, for a number of reasons this has not occurred. In all transition economies, before any growth has occurred (and in some countries there is no growth yet) there has been severe contraction, ranging from 20 per cent over three years in Poland, to over 60 per cent in nine years in Ukraine (Table 1). These unfavorable results are the consequence of both the legacy of the previous system and the policies exercised during transition, though it is obvious that the latter are of major importance.

Table 1: Recession and Growth in Transition Economies, 1990-97

Countries	Years of GDP decline	Did GDP fall after some growth?	Average annual rate of GDP growth			1997 GDP index (1989 = 100)	Rank
			90-93	94-97	90-97		
Poland	2	no	-3.1	6.3	1.6	**111.8**	**1**
Slovenia	3	no	-3.9	4.0	0.0	**99.3**	**2**
Czech Republic	3	**yes***	-4.3	3.6	-0.4	**95.8**	**3**
Slovakia	4	no	-6.8	6.3	-0.3	**95.6**	**4**
Hungary	4	no	-4.8	2.5	-1.1	**90.4**	**5**
Uzbekistan	5	no	-3.1	-0.3	-1.7	**86.7**	**6**
Romania	4	**yes**	-6.4	2.1	-2.2	**82.4**	**7**
Albania	4	**yes**	-8.8	4.9	-2.0	**79.1**	**8**
Estonia	5	no	-9.7	4.1	-2.8	**77.9**	**9**
Croatia	4	no	-9.9	3.0	-3.4	**73.3**	**10**
Belarus	6	no	-5.4	-2.6	-4.0	**70.8**	**11**
Bulgaria	6	**yes**	-7.4	-3.6	-5.5	**62.8**	**12**
Kyrgyzstan	5	no	-9.3	-2.4	-5.8	**58.7**	**13**
Kazakhstan	6	no	-6.7	-6.0	-6.3	**58.1**	**14**
Latvia	4	**yes**	-13.8	2.2	-5.8	**56.8**	**15**
Macedonia	6	no	-12.9	-0.8	-6.9	**55.3**	**16**
Russia	7	**yes***	-10.1	-5.3	-7.7	**52.2**	**17**
Turkmenistan	7	no	-4.5	-12.5	-8.5	**48.3**	**18**
Lithuania	5	no	-18.3	0.5	-8.9	**42.8**	**19**
Armenia	4	no	-21.4	5.4	-8.0	**41.1**	**20**
Azerbaijan	6	no	-14.5	-5.7	-10.1	**40.5**	**21**
Tajikistan	7	no	-12.2	-8.4	-10.3	**40.0**	**22**
Ukraine	8	**no recovery**	-10.1	-12.1	-11.1	**38.3**	**23**
Moldova	7	**yes***	-12.6	-10.2	-11.4	**35.1**	**24**
Georgia	5	no	-24.1	2.9	-10.6	**34.3**	**25**

Source: National statistics, international organizations and author's own calculations

* GDP contracted again in 1998

These policies were based to a large extent on the so-called Washington consensus. The set of policies designed along this line has been stressing the importance of liberalization, privatization, and opening of postsocialist economies as well as the necessity of sustaining financial discipline. However, being developed for another set of conditions, initially this approach was missing crucial elements necessary for systemic overhaul, stabilization, and growth. These elements included institution building, improvement of corporate governance of the state sector prior to privatization, and the redesign of the role of the state, instead of its urgent withdrawal from economic activities. The incorrect assumption that emerging market forces can quickly substitute the government in its role toward new institutional set up, investment in human capital, and development of infrastructure, have caused severe contraction and growing social stress.

The need to manage the institutional aspects of transition have been recognized and addressed only in later stages. The technical assistance of the International Monetary Fund and the World Bank with dealing with these issues may have an even more important positive influence on the course of transition and growth than their financial involvement. Lending by these organizations is often called 'assistance', despite the fact that these are just commercial credits with tough accompanying terms. They are having the consequence of enforcing far reaching structural reforms and pushing towards policies that suppose to bring durable growth.

Hence, there is the need to search for a new consensus about policy reforms necessary for sustained growth. The east Asian contagion, east European transition and Brazilian crisis do suggest that for recovery and durable growth healthy financial fundamentals and liberal, transparent deregulation are not the only decisive factors. Sound institutional arrangements, re-regulation of financial markets and wise policy of the governments are also essential. Against the recent experience with the crises of several emerging markets (including the ones in transition countries) the outline of a new consensus—a post-Washington consensus—can be drawn. It points not only to the need for liberal markets and open economies, but stresses the new role of the state, the fundamental meaning of market organizations and the institutional links between them, and the need for more equitable growth.

After losing over a quarter of GDP between 1990-98 majority of the postsocialist transition economies are gaining momentum. If this is not yet true in the two most sizable, i.e. Russia and Ukraine, they too have the chance to become growing economies (Kolodko 1998). In the coming years, the postsocialist emerging markets will become not only rapidly growing economies, but—owing to the east Asian turmoil—the fastest growing region in the world. Yet how fast this growth is going to be, depends on policy reforms implemented in particular countries. The direction of these reforms will also depend on cooperation with international organizations and their technical advice and financial support, which are conditionally linked to execution of market-friendly policies and implementation of sound structural reforms. Thus these organizations' influence upon the course of reforms and chosen policies is much stronger than their actual financial engagement and undertaken risk.

2. Policy Without Growth: Missing Elements

From the beginning of this decade the so-called Washington consensus has been accepted as common wisdom on policies for movement from stabilization to growth. It was assumed that tough financial policy accompanied by deregulation and trade liberalization would be sufficient to conquer stagnation and launch economic growth, especially in the less developed countries toward which the Washington consensus was addressed. Despite the fact that the policy reforms advised by this line of thought were at that time mostly relevant to the Latin American experience, they were applied to structural crisis issues in other regions, including transition economies. Later, there was an interaction between the theories and the practice, a process of learning by doing. On one hand, the orientation of these policy reforms has had an important influence upon the course of postsocialist transition. On the other hand, the transition process has had an impact on policy as well.

A summary of the 1989 Washington consensus was given by John Williamson (1990), which named the proposed set of policies, stressing the importance of the organizations involved. He enumerated 10 points that at the time seemed to be agreed upon by influential financial organizations, political bodies, and professional economists:

> - *Fiscal Discipline. Budget deficit...should be small enough to be financed without recourse to the inflation tax...*
> - *Public Expenditure Priorities. Expenditure should be redirected from politically sensitive areas ... toward neglected fields with high economic returns and the potential to improve income distribution....*
> - *Tax Reform. Tax reform involves broadening the tax base and cutting marginal tax rates. The aim is to sharpen incentives and improve horizontal equity without lowering realized progressivity. ...*
> - *Financial Liberalization. The ultimate objective of financial liberalization is market-determined interest rates, but experience has shown that, under conditions of a chronic lack of confidence, market-determined rates can be so high as to threaten the financial solvency of productive enterprise and government. ...*
> - *Exchange Rates. Countries need a unified (at least for trade transactions) exchange rate set at a level sufficiently competitive to induce a rapid growth in nontraditional exports and managed so as to ensure exporters that this competitiveness will be maintained in the future.*
> - *Trade Liberalization. Quantitative trade restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low tariff in the range of 10 percent (or at most around 20 percent) is achieved. ...*
> - *Foreign Direct Investment. Barriers impeding the entry of foreign firms should be abolished; foreign and domestic firms should be allowed to compete on equal terms.*
> - *Privatization. State enterprises should be privatized.*
> - *Deregulation. Governments should abolish regulations that impede the entry of new firms or that restrict competition, and then should ensure that all regulations are justified by such criteria as safety, environmental protection, or prudential supervision of financial institutions.*
> - *Property Rights. The legal system should provide secure property rights without excessive costs and should make such rights available to the informal sector.*
>
> Williamson 1997, p. 60-61

Later, mainly under the influence of experience with overhauling the Latin American economies over the first half of 1990s and taking into consideration the lessons learned from Eastern Europe and the former Soviet Union, the new agenda was presented. Whereas it includes obvious points from earlier thoughts, there are certain new concerns and accents. Again, 10 points were raised:

- *Increase saving by (inter alia) maintaining fiscal discipline*
- *Reorient public expenditure toward (inter alia) well-directed social expenditure*
- *Reform the tax system by (inter alia) introducing an eco-sensitive land tax*
- *Strengthen banking supervision*
- *Maintain a competitive exchange rate, abounding both floating and the use of the exchange rate as a nominal anchor*
- *Pursue intra-regional trade liberalization*
- *Build a competitive market economy by (inter alia) privatizing and deregulating (including the labor market)*
- *Make well-defined property rights available to all*
- *Build key institutions such as independent central banks, strong budget offices, independent and incorruptible judiciaries, and agencies to sponsor productivity missions*
- *Increase educational spending and redirect it toward primary and secondary school.*

Willimason 1997, p. 58

The new items on this agenda correctly address the issues of institution building, environmental protection, and investment in education, yet they are still missing some points of great importance which are especially pertinent to transition economies. First of all, dealing with corporate governance reform in the state sector before privatization is not mentioned, nor is the behavioral aspect of institution building. Also the necessity of equitable growth is still overlooked. The shortest point on the agenda of the early Washington consensus, i.e. "Privatization. State enterprises should be privatized," is in reality a long-term policy challenge. Even if there is a sound commitment to privatize quickly and extensively—which is not always the case—it is not feasible, for both technical and political reasons. There are also the issues of sequencing, pace, distribution of costs and benefits, and the efficient exercise of corporate governance.

As for the institutional aspect of reform, in postsocialist transition economies, unlike in distorted developing market economies, it is not enough merely to establish organizations, for instance, an independent central bank or comprehensive tax administration. Cultural changes are also necessary to facilitate efficiency and growth, changes in behavior within organizations and changes in the interactions between them.

The early Washington consensus was actually aiming at countries that had already market economy, and were not just in a transition to such a system. Joseph Stiglitz (1998a), while stressing the importance of governments as a complement to markets points out that the consensus achieved in the late 1980s and early 1990s between the United States Treasury, the IMF, and the World Bank, as well as some influential think tanks, was catalyzed by the experience of Latin America in the 1980s. He claims that for this reason countries facing different challenges have never found satisfactory answers to their most pressing questions in the Washington consensus. Its simplified interpretation vis-à-vis the postsocialist economies implied that it would be sufficient to fix the appropriate financial fundamentals and privatize the bulk of state assets. Subsequently, growth should begin and continue for the long term. Because this has not happened as presumed, the Washington consensus must be reconsidered.

There has always been a question as to the actual existence of a Washington consensus. Was a consensus achieved, or was the effort just an intention and well-motivated attempt? In fact, the latter is the case. *There is no standard terminology for these sets of doctrines, and various practitioners advocated these doctrines with varying degrees of subtlety and emphasis. The set of views is often summarized as the "Washington consensus", though to be sure, there never was a consensus even in Washington (let alone outside of Washington) on the appropriateness of these policies.* (Stiglitz 1998b, p. 58)

The partial failure of the Washington consensus with regard to transition economies must be linked with the neglect of the significance of institution building for the beginning of growth, even if economic fundamentals are by and large in order. Such oversight explains why so many Western scholars initially did not properly understand the real problem. Institutions change very slowly, but they have a strong influence on economic performance. As the 1993 Nobel Laureate in Economics states, since

> *...Western neo-classical economic theory is devoid of institutions, it is of little help in analyzing the underlying sources of economic performance. It would be little exaggeration to say that, while neo-classical theory is focused on the operation of efficient factor and product markets, few Western economists understand the institutional requirements essential to the creation of such markets since they simply take them for granted. A set of political and economic institutions that provides low-cost transacting and credible commitment makes possible the efficient factor and product markets underlying economic growth.*
>
> North 1997, p. 2

Expectations of growth were based on the assumption that market institutions, if they had not yet appeared automatically, would somehow rise up soon after liberalization and stabilization measures were executed. It was believed that if policies were put in place to secure the progress of stabilization and enhance sound fundamentals, the economy should regain momentum and start to develop quickly. However, what actually happened was much more depressing. Because of a vacuum with neither plan nor market system, productive capacity was utilized even less than previously, savings and investments began to decline, and instead of fast growth there was deep recession. A lack of institutional development turned out to be the missing element in transition policies based on the Washington consensus. Instead of sustained growth, liberalization and privatization without a well-organized market structure led to extended contraction. This was not only the legacy of a socialist past, but also the result of current policies.

Under some circumstances, though not in every case, the manner of reasoning characteristic of the Washington consensus may be relevant to the challenges faced by distorted less developed market economies. Contrary to the experience of postsocialist economies, in these cases certain market organizations have always been in place. In postsocialist countries, however, organizations essential to a market economy were either distorted or did not exist, so the economy could not expand. Some institutions must be developed from scratch, since they did not exist under the centrally planned regime. Hence, even with progress in liberalization and radical privatization, there was still no positive supply response. Misallocation of resources and investments has continued, although this time for different reasons.

At the outset of transition the only relatively developed part of a market infrastructure was a commodities trading network, but even this was operating under chronic shortages. A capital market structure was nonexistent. The lack of financial intermediaries discouraged accumulation and worsened allocation of savings. Thus, immediately after the collapse of socialism, the lack of proper regulation of the emerging capital market and the dearth of such key organizations as investment banks, mutual funds, a stock exchange, and a security control commission, etc, caused distortions that could not be offset by liberalization and privatization.

All these organizations and institutional links must be developed gradually. Considering the point of departure, this also calls for a process of retraining many professionals to enable them to work in the market environment. This takes years, and thus it would be much wiser to manage the processes of liberalization and privatization at a pace compatible with the speed of human capital development. Otherwise, loosed market forces will not be able to shape economic structures and processes and raise competitiveness and ability for growth. A dissonance between liberalization measures and institution building has actually occurred in a number of countries that took a bit more radical approach toward transition. In these cases "creative destruction", popular in Poland at the beginning of 1990s, failed to deliver, because there was too much destruction and not enough creation.

Socialist countries were full- or over full-employment economies, i.e. economies with labor shortages. Thus a social security system protecting against unemployment did not exist, because it was not needed. All countries in this region must develop such a safety net from scratch.[1] In the meantime, before such systems could be implemented, in addition to the misallocation of capital, there has been the misallocation of labor.

Since the mid 1990s, the Bretton Woods organizations have started to pay more attention to the way market structures are organized as well as to the behavioral aspects of market performance. A number of less developed and transition economies have learned quickly that there is no sustained growth without sound fundamentals. Later, it was learned and accentuated too, that the market and growth need both: the liberalization and the organization. Now, due to the experience of transitional contraction and because of conclusions drawn from the East Asian crisis, we learn that even with sound fundamentals, i.e. a balanced budget and current account, low inflation, a stable currency, liberalized trade, and a vast private sector, there will not be sustained growth if these favorable features are not supported by an appropriate institutional set-up. Actually, without such a set up, the fundamentals themselves will become unsound and unsustainable, what time and again is proved by the actual developments, for instance in the Czech Republic or more recently in Brazil.

There seems to be a growing agreement that the early Washington consensus must be revised and adjusted toward actual challenges and new circumstances. If it is going to work, elements so far missing must be included. These elements are linked with institutional arrangements, though they are not universal. Some other elements were missing regarding the overhauling of the Latin American debt crisis, some others in the case of counteracting the

[1] From this angle, the Chinese reforms in the late 1990s go along a different line than the earlier Eastern European reforms. China now accepts open unemployment, which in 1998 officially exceeded four per cent.

Eastern Asia's contagion, and still others in fighting the Eastern European transitional depression. In the latter, eight elements are of key importance:

- The lack of organizational infrastructure for a liberal market economy.
- Weak financial intermediaries unable to allocate efficiently privatized assets.
- A lack of commercialization of state enterprises prior to privatization.
- Unqualified management unable to execute sound corporate governance under the conditions of a deregulated economy.
- A lack of institutional infrastructure for competition policy.
- A weak legal framework and judiciary system, and a consequent inability to enforce tax code and business contracts.
- Poor local government unprepared to tackle the issues of regional development.
- A lack of non-governmental organizations (NGOs) supporting the functioning of the emerging market economy and civil society.

Hence, policies that under other conditions may have worked, were not effective in overcoming the crisis in the postsocialist economies. Even if the targets and instruments as such were well defined, they could not be reached and used as envisaged, since they were put into use within a systemic vacuum.

3. Toward a New Consensus

Rather than a permanent agreement between principal partners, the process of developing new consensus must involve a constant search for such agreement as well as a quest for new partners. These features are indispensable for its ultimate success. From time to time, when the situation changes and our knowledge about it evolves, new documents and programs, accentuating additional points of concern and examining old points in a different light, come to the fore. A good example of such progress is the World Bank's 1996 Annual Development Report, devoted entirely to the transition from plan to market (World Bank 1996), and the September 1996 IMF Interim Committee Declaration on a *Partnership for Sustainable Global Growth* (IMF 1996).

The latter statement may be seen as a modified version of the early Washington consensus. Among eleven points, six are of special relevance to the situation of transition economies. Point one stresses that monetary, fiscal, and structural policies are complementary and reinforce each other. Point three claims that there is the need to create a favorable environment for private savings. Point seven accentuates that budgetary policies have to aim at medium-term balance and a reduction in public debt, while point nine says that structural reforms must be supplemented with special attention paid to the labor markets. Point ten stresses the importance of good corporate governance, and point eleven cautions against corruption in the public sector and money laundering in the banks, warning that their monitoring and supervision must be strengthened. Other points, also important for sustainable development, address the issues of exchange rate stability, disinflation, resisting protectionist pressure, progress toward increased freedom of capital movement, and fiscal adjustment by reducing unproductive spending while ensuring adequate investment in infrastructure.

However, the Washington consensus is not an official position taken by any particular organization or institution. It is rather a gathering of policy options being agreed upon by important partners to such an extent that the agreement may be considered a consensus. Yet there is still a search for agreement between the organizations as well as among the policymakers, policy-oriented researchers and advisors. Being personally involved in all three, i.e. research, advice giving, and policy-making, it was quite interesting for me to receive a reaction to the outcome of my involvement from the author of the Washington consensus. John Williamson[2] has stressed that:

> *I was particularly pleased that you have tried to define an alternative to big bangery in terms of a more careful design of individual policy components rather than generalized go slow ("gradualism").*[3] *On just about all the individual items you identify, certainly including protection and privatization, I agree with you in retrospect, and indeed I would have agreed with you at the time... But in all honesty I have to confess that I still worry that had I been in the place of Balcerowicz* (who was the minister of finance in Poland in 1989-91) *I might not have put together the decisive package that I think in retrospect Poland needed at the time, and that laid the foundation for your successful period in office. Perhaps one needed a little bit of overkill to make it emotionally possible for your allies to accept that the world had changed, and even to give you the opportunity of correcting their excesses and in the process winning their acceptance of the new model? It reminds me of the situation in my home country: I am much more comfortable with Tony Blair than with Mrs. Thatcher, but I am not sure that we could have had him without her.*

This time, psychological and political rather than economic and financial arguments are given as decisive factors favoring the radical set of policies undertaken at the beginning of the 1990s. Nonetheless, it seems that we still differ as for the evaluation of the scope and costs of that overkill. Was it only 'a little bit' of otherwise necessary measures, as one may still believe, or was it a serious excess of unnecessary radicalism, as it seems to be proved elsewhere (Kolodko 1991, Nuti 1992, Rosati 1994, Poznanski 1996, Hausner 1997)?

When ideas and strategies involving more gradual change and the active involvement of the state in institutional redesign in postsocialist transition economies were expounded first time (Kolodko 1989 and 1992, Laski 1990, Nuti 1990, Poznanski 1993), and when they were later implemented in Poland (Kolodko 1993, 1996 and 1999), they were unorthodox and controversial, with respect to the Washington consensus. In fact, these new ideas did not so much endorse more gradual change, but recognized that the necessary changes would be time-consuming by their very nature. In 1997 and 1998, however, even in official international circles, there have been widespread signs that a new consensus is emerging, and that it is, to a certain extent, based on the ideas implemented in Poland in 1994-97 (Kolodko and Nuti 1997). Thanks to its multi-track approach, Poland is now recognized to have avoided the adverse

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2 Direct communication between the authors.

3 This alternative regards policy reorientation executed under the medium-term transition and development program 'Strategy for Poland' (Kolodko 1996), when the author was Poland's First Deputy Premier and Minister of Finance in 1994-97. The outline and implementation of this program compared with the earlier policies are described as The Polish Alternative in Kolodko and Nuti (1997).

experience of other transition economies. The new ideas and policies, developed under 'Strategy for Poland', were to some extent elaborated against the mainstream of the early Washington consensus and now have contributed importantly to its revision.

In the aftermath of the Southeast Asian crisis, as it has spread beyond anybody's expectation, the train of thought has also begun to change track among the most influential opinion leaders in the international financial community. This has been accompanied by a much belated beginning of doubt raising regarding the accuracy of the recipe proposed for postsocialist emerging markets, especially for the most important, i.e. Russia. A consensus has not yet been agreed upon, but lessons are gradually being learned. It is now admitted that,

> *The benefits brought by short-term international lenders are questionable: they do not provide new technology, they do not improve the management of domestic institutions; and they do not offer reliable finance of current account deficit. In countries with high savings rates, they also increase already excessive investment rates. To manage the inflows, borrowers may have to accumulate huge reserves... The Asian saga proves, once again, that liberalization of inadequately regulated and capitalized financial system is a recipe for disaster.*
>
> Wolf 1998

All the while, the Bretton Woods organizations were insisting upon, and determining their financial involvement based on tough fiscal and monetary policy. If it was a period of 10 per cent GDP decline, or a period of 10 percent expansion, there was always pressure to bring the fiscal gap down and keep the real interest rate up. Even when the budget deficit was smaller than that of industrial countries and the real interest rate was so high that it was not possible to contain the deficit further due to soaring costs of servicing the public debt, there was a permanent requirement on continuing fiscal and monetary tightness. High real interest rate facilitates fine the portfolio investors (through the interest rate differentials), but at the costs of both budget, i.e. taxpayers and the business sector owing to crowding out effect.

The importance of a change in corporate governance—as opposed to a sheer transfer of property titles—is now being recognized even by early keen supporters of rapid, mass privatization. There is no clear evidence that the privatized enterprises perform better than state enterprises just in the aftermath of privatization. Nicholas Stern (1996, p. 8) points to the process of restructuring, which *...itself will be a major and fundamental task involving investment, hard decisions and dislocation. It will be much less painful if economic growth, effective corporate governance and well-functioning safety nets are established.* Thus good corporate governance of the public enterprises and sound competition policy are at least as essential for recovery as privatization and liberalization.

After the laissez-faire of the early transition, values of co-operation and solidarity are being rediscovered. Even billionaire financier George Soros has not hesitated to admit that, *Although I have made a fortune in the financial markets,*[4] *I now fear that the untrammeled intensification of laissez-faire capitalism and the spread of market values into all areas of life is endangering our open and democratic society...Too much competition and too little cooperation can cause intolerable inequities and instability.* (Soros 1997) Yet it should be obvious from the outset that transition based upon a sort of laissez-faire must bring 'intolerable inequities and instability'

[4] Including those of transitional economies, of course.

(Kolodko 1999), it is still not acknowledged widely enough and such an obvious conclusion is still challenged.

Yet the World Bank 1996 *World Development Report* emphasizes very strongly the need for social consensus, though it was very difficult to reach a such, considering falling output and growing inequality in transition economies. *Establishing a social consensus will be crucial for the long-term success of transition – cross-country analyses suggest that societies that are very unequal in terms of income, or assets tend to be politically and socially less stable and to have lower rates of investment and growth.* (World Bank 1996)

It is now rather accepted that in economies still affected by structural rigidities, such as formal and informal indexation and sluggish supply response, once inflation has fallen well below a threshold of about 20 per cent, attempts at speeding up disinflation would have had significant, perhaps intolerable costs -- as for instance in Romania in 1998-99 -- certainly higher than the moderate, but steady falling inflation actually experienced by some countries leading in transition and those recently following Poland's path. What counts is that inflation should continue to fall steadily and noticeably, without ever accelerating again. Such a process of disinflation contributes not only to growing credibility of the government and monetary authorities, but secures the predictability of economic developments and creates a better business environment and confidence on the international scene.

The prerequisite for an enhanced savings ratio, i.e. faster than income increase, is a growth of real income, stabilization, and optimistic expectations. Only against such background can the propensity to save steadily increase. The 1996 EBRD *Transition Report*, which is devoted to infrastructure and savings, stresses the equal role of increasing government savings—especially through the overhaul of social security and pension systems, and more broadly based taxation at lower rates—and the development of contractual savings and life insurance. From this perspective, the pressure for high and positive real interest rates has been grossly misplaced. The fiscal and quasi-fiscal activities of central banks, notably in the emerging economies and especially in postsocialist countries, have attracted considerable attention (Fry 1993). In particular, the costs of sterilization policies, which are the result of excessive interest rate differentials and/or of undervalued currencies, have come to the fore, e.g. the OECD country study of the Czech Republic (OECD 1996). It turns out that for a considerable time, the central banks of both the Czech Republic and Poland have wasted about 1 per cent of GDP in their unfortunate sterilization policies (Nuti 1996).

There is yet one more key feature of the emerging consensus. This time, along with the continuous leading role of the Washington-based organizations, especially the IMF and the World Bank, it must encompass more partners. Other international organizations, like the UN, OECD, WTO, ILO, and EBRD, should play a bigger role than they have thus far. Also, regional organizations, like ASEAN in Asia, CEFTA in central Europe, or the CIS in the former Soviet Union, should be better prepared to present their purpose in the global forum and try to influence the process of changing the international financial and economic order. Some international NGOs ought to be more influential too.

Thus the search for the new consensus must rely not only on the quest for new policies agreed in Washington, but also on the policies agreed between Washington and other important places in different parts of the global economy. There are many hints that such process is on the way, but there is much more yet to be accomplished.

4. The Means and Ends of Economic Policy

The lack of success of policies based on the early Washington consensus is also due to the confusion of the means of the policies with their ends. A sound fiscal stance, low inflation, a stable exchange rate, and overall financial stabilization are only the means of economic policy, while sustained growth and healthier standard of living are its ends. Yet after several years of exercising these policies, neither growth nor a higher standard of living has been achieved in transition countries. Important changes like privatization and liberalization are merely instruments, not targets. So it is strange that so often these instrumental processes are presented as a core of economic policy, if not its ultimate end. Too much attention is focused on the means that hypothetically should lead to improvement of efficiency and competitiveness, instead of concentration on the outcome of these exercises. Such bias leads to policy's distortion and the tools become the goals themselves, without sufficient concern about their impact on the real economy.

In economic policy sometimes it happens that intellectual oversimplification assumes that, from a certain point and under certain circumstances, the things should run themselves, so there is no need to think about how to manage them. An extreme example of such thought is the supposition that 'the best policy is no policy'.[5] But, considering the distinction between ends and means, it should be obvious to all those involved in economic research, advice, and policy, that such confusion cannot be explained merely by the naiveté and laziness of economists and politicians. Actually, they do work hard. The intellectual misunderstandings result from political antagonism, and the difference is more about conflicts of interests than about alternative theoretical concepts and scientific explanations.

Of course, it does happen that policy mistakes occur due to a lack of experience and proper knowledge, but more often this confusion stems from obedience to a particular group of interests, or to 'theoretical schools', that happen to be ideological and political lobbies too. This is why there are no leftist or rightist doctors or engineers, but there are leftist and rightist economists and policymakers. John Williamson (1990) points to 'political' and 'technocratic' Washington, stressing their different priorities and policy options. However, there are important divisions not only *between* the 'political' and 'technocratic' parts of Washington, but also *within* them.

What makes the picture still more complex, is the fact that some of the actors on the so-called 'technocratic' side of the scene do play, even if unintentionally, political roles as well. This is also true with regard to the Bretton Wood organizations, especially the IMF. Their influence and the consequences of their policies simply have such serious implications for particular countries and regions, if not the entire global economy, that sometimes they have much more to say —and decide—than what may be seen as purely 'technocratic' concerns. The position of the IMF towards such big countries in transition as Russia and Ukraine are the best points in case here.

But the issue is even more complex than that, because—aside from intellectual controversies and different normative values—there are also different political, economic, and financial interests involved. Otherwise it would be impossible to interpret why erroneous policies had continued, in many cases, even after it was obvious that they were wrong. These were the cases, for instance, with early liberalization and stabilization policy in Poland in 1989-1992, the neglect of corporate governance in the Czech Republic in 1993-96, the Russian

[5] That was a declaration (and, unfortunately, a way of dealing) of the Minister of Industry and Trade of the Polish government at the time of "shock therapy", which happened to be shock without therapy.

privatization of 1994-98, executed with the active involvement of politically connected informal institutions, and with fraudulent Albanian financial intermediaries in 1995-97, which were tolerated until the whole economy eventually collapsed.

Such events serve only as examples of the confusion of economic policy's targets with its instruments. Economic policy is not to be judged by the pace of privatization, but by its efficiency, measured first by the increase of competitiveness and budgetary proceeds, and then by the increase in contribution to national income. The strong insistence for privatization's acceleration coming from some lobbies and their political allies is merely a means to sell the assets cheaper. Thus there are entities that are able to buy these assets not faster, as is publicly suggested through political connections and dependent news media, but to acquire them cheaper than under a more reasonably paced procedure. The ones that sell fast, sell cheap too. And the ones, who buy fast, buy cheap as well.

There have been warnings, criticisms, and intellectual and political opposition against all these unwise policies, but still they have gotten through. Why? It has occurred not due to a lack of good economic ideas or a deficit of sound policy programs, but because of pressure from strong lobbies and interest groups. Therefore, in designing good policy, it is important not only to be right but also to be able to enforce the preferred policies. Often it happens that the strongest lobby is not there where are the truth and the logic, but where are the power and the money.

Therefore, true reforms, those that facilitate the public interests of many as opposed to the particular interests of a few, must always be thought of as a means to long-term targets, i.e. sustained growth. Otherwise, there will be fictitious 'progress' reflected in an artificial improvement of situation. If the share of private sector, the scope of trade liberalization, or the deregulation of capital transfers are bigger than it would be without these policies, but at the same time economic contraction is deeper or growth more sluggish and the standard of living is deteriorating, then the overall situation is worse, not better. Yet, often, economic status is judged from the perspective of a particular group of interests and this perspective is presented as a picture of the general economic situation.

So, while evaluating the actual standing of an economy and policy, one must consider not only what is examined, and by what means it is scrutinized, but also who is carrying out such an evaluation. With this in mind, it is obvious that, for instance, the evaluations of Moody's rating agency and the Russian trade unions must be as different as the interests of the Morgan Stanley investment bank and the Siberian miners.

Hence, the aims of development policy are more comprehensive and their interpretation is changing as well among those who subscribed to the Washington consensus, primarily the World Bank. Not only should a balanced economy and sustained growth be of serious policy concern, but also standard of living improvement, distribution of income, the environment, and, last but not least, democracy itself. *Our understanding of the instruments to promote well-functioning markets has also improved, and we have broadened the objectives of development to include other goals, such as sustainable development, egalitarian development, and democratic development.* (Stiglitz 1998a, p. 1) True, the World Bank always was more inclined toward social issues and development of human capital than other international financial institutions, unlike just any other bank. Usually banks look to profits, not to the human development index as an indicator of their success. It must be acknowledged that the World Bank has become involved in a number of projects, not only in transition economies, that serve to increase standards of living and decrease poverty.

Yet now even the IMF is trying to join the club and claim that it too would like to aim at a more fair distribution of the fruits of growth, if only the advised policies would deliver some. Stanley Fischer, the IMF First Deputy Managing Director, himself concerned about equitable growth for a long time, has raised the question *Why do equity considerations matter for the Fund?* And then has answered that:

> *First, as a matter of social justice, all members of society should share in the benefits of economic growth. And although there are many important arguments about precisely what constitutes a fair distribution of income, we accept the view that poverty in the midst of plenty is not socially acceptable. But, second, there is also an instrumental argument for equity: adjustment programs that are equitable and growth that is equitable are more likely to be sustainable. These are good enough reasons for the IMF to be concerned about equity considerations - whether it be poverty reduction or concerns about income distribution in the programs the IMF support.*
>
> Fischer 1998, p. 1

Undoubtedly, the experience of transformation has contributed significantly to these changes. We still have to deal with difficult road from contraction to growth in postsocialist economies, but we have also experienced fast growth in Asian reformed socialist economies, which -- unlike the Eastern European and the former Soviet Union transition economies -- did not follow many early Washington consensus suggestions. Now these experiences—together with the aftermath of the Southeast Asian crisis and its contagion—are working as a catalyst for the emergence of 'the post-Washington consensus' the same way that the Latin American debt crisis of the 1980s ignited the formation of its predecessor. However, there is still a long distance to travel from the emerging intellectual consensus to a real political agreement about appropriate policy reforms and actions. And, of course, even if intellectual consensus is closer than before, controversies regarding different normative values and contradictory interests do remain.

5. Transition as a Process of Systemic Redesign

The only chance for the ultimate success of transformation is to design suitable institutions, which often must be developed from the beginning. This design is more difficult in post-Soviet republics than in Eastern Europe, because in the former there was a lack of even such basic institutions as a sovereign central bank or national currency, and private property of the means of production was virtually non existing. In Asian reformed socialist economies the process is going at much slower pace and yet it also is directed at further liberalization and opening up.

As for postsocialist countries, some have taken a course of gradual, perhaps even too slow liberalization and privatization. Though that was followed by relatively milder contraction, it caused a delay of crucial structural reforms as well. Nevertheless, if the given time is used for appropriate institution building, it can pay off later. If, however, the time of gradual liberalization is wasted from the perspective of institutional reforms, than the chance for a long-term expansion is indeed weak. Some countries follow a path of rapid change.

Although under these circumstances contraction was more severe in early stages, later, institution building is often more advanced. In the long-run, after learning the bitter lesson that market economies do not expand without a wise government-led development policy and well-designed institutions, both types of economies, i.e. European and former Soviet economies in transition as well as the reformed economies of China and Vietnam, have a chance to succeed in their market endeavors.

The government involvement in the process of comprehensive institution building is of vital importance. Truly, this, as much as the liberalization, is the essence of transition. In other words, without taking adequate care of institutional arrangements, solely liberalization and privatization is unable to deliver what the nations expect from their economies. Thus, if the state fails to design a proper institutional set up, then market failures prevail and informal institutionalization takes over. Instead of a sound market, in the words of the chief economists of the World Bank and the European Bank of Reconstruction and Development, a 'bandit capitalism' does emerge.

> *It is easy to identify institutional arrangements that work well: each partner does what it is supposed to do, there is good coordination, little conflict and the economy grows smoothly and rapidly. We can also recognise ill-functioning institutional arrangements: change is inhibited by bureaucratic requirements or there is "bandit capitalism" with pervasive corruption and deceit.*
>
> Stern and Stiglitz 1997, p. 20

Such institutional pathologies could arise as a result of transition-by-chance, as opposed to transition-by-design. In several cases inaccurate transition policy has led to such adversity. A system where 'only the stupid pay taxes', the contracts are not executed as agreed, or the payments are not made on time, is hardly a market economy. It is rather chaos stemming from institutional disintegration.

Without the knowledge of how a new system works, and without a vision of how to get to that system, there is no way to accomplish to target on time and in good shape. Transition becomes protracted: costs are higher than necessary, while results are not as good as they could be under an alternative scenarios, and the whole process lasts longer than would otherwise be necessary. And, as was stressed by the advocates of transition-by-design contrary to the supporters of transition-by-chance, the recession lasts longer, recovery comes later, and output expands more slowly (Poznanski 1996). Thus the proper institutional design is a paramount task during the time of transition. At the same time, its accomplishment is more difficult than elsewhere, because of institutional discontinuity. The old set up, for instance, central price regulation, or the investment's allocation by Gosplan and branch ministries, does not work anymore, the new one, for instance, investment banking, or stock exchange, is not yet in place. Thus the systemic vacuum prevails.

A foundation for market capitalism requires the dominance of private property, but also a competitive enterprise sector, functioning markets, and respect for the rules of market allocation. Well-performing financial intermediaries are necessary to facilitate trade transactions and investment deals, as well as to promote savings. But the market, its introduction notwithstanding, also needs a proper legal environment, one that is able to support execution of market rules, enforcement of contracts, and the correct behavior of economic agents (firms, households, organizations, and the government). For these reason transition calls not for a dismissal of government, but for its streamlining and adjustment to the new circumstances. The World Bank, unlike the advocates of market fundamentalism, admits that:

The state makes a vital contribution to economic development when its role matches its institutional capability. But capability is not destiny. It can and must be improved if governments are to promote further improvements in economic and social welfare (...) Three interrelated sets of institutional mechanisms can help create incentives that will strengthen the state's capability. These mechanisms aim to:

- Enforce rules and restraints in society as well as within the state
- Promote competitive pressures from outside and from within the state, and
- Facilitate voice and partnership both outside and within the state.

World Bank 1997

This is true for all economic systems, countries with differing scopes of economic activity, various GDP levels, and odd institutional advancement, so it is even truer for transition economies. In countries where the rules were previously fundamentally different from current postsocialist regulations, the introduction of new behaviors and the enforcement of new regulations for economic entities calls for even harder and more determined state effort than elsewhere.

Unfortunately, the state's ability to attack the issue of law enforcement is much weaker during transition than it was under state socialism. It is also weaker than under the governments of traditional market economies, with mature civil societies and well-working institutions. Postsocialist states have been deliberately weakened by neo-liberal policies, often led with the official support of the governments of leading industrial countries and the international organizations.

For example, the Russian government is weak and unable to collect due taxes not because of the legacy from the communist period, but owing to ill-advised liberal approach and wrong deregulation and privatization. Now it is difficult to bring things under the sovereignty of the new state, because they have been allowed to get out of control of the old state, mainly because of mismanaged liberalization and the manner the institutional redesign occurred.

As for new partnerships between market players, that is precisely what gradual institution building is about. In the long-term, such partnerships enhance the environment for growth, but at the initial stages ongoing changes can destabilize existing links between partners involved in economic activities. The old relationships cease to exist, while the new ones are only in *statu nascendi*. Thus the active state participation is needed, since market relations are often associated with inappropriate events owing to activities of various lobbies and informal organizations, including the organized crime.

6. Transition as an Instrument of Development Strategy

The new institutional set up must be founded on the basis of new organizations that did not exist—since they were not needed—under the centrally planned state economy. Transition calls not only for a new legal system, but also for learning a new type of behavior. Enterprises, banks, the civil service and state bureaucracy, even households—all of them must quickly learn how to perform under the circumstances of new reality, i.e. emerging market system. Political leaders in postsocialist countries do not have, as Moses did, 40 years to turn their people around. To accelerate this process and cut the costs of institutional and cultural adjustment require special training and education efforts by political and intellectual elites, and non-governmental organizations (NGOs). The Bretton Woods institutions are contributing to this acceleration. After seeing that sometimes providing new skills and knowledge is more important than just lending money, they have started to pay much more attention to technical assistance and professional training.

In countries that enjoyed a relatively liberal system under socialism, the process of learning goes much faster. If there was already a private sector and decentralized management of state companies, learning new methods of corporate governance is smoother. If there was already a two-tier banking system, learning sound commercial banking is easier. If there was already an anti-trust body, this previously relatively useless organization (because of the shortages) now must regulate well-supplied markets to make them truly competitive.

In countries, which had traditional centrally planned regimes until the late 1980s, learning is slower. This factor explains the differences in the economic performance of such neighbors as Hungary, on one hand, and Romania, on the other. The faster is the process of institution building, the better is the environment for business activity and hence for growth. Government guidance and intervention can hasten the whole process, as it was done in Poland in the 1990s, but—if mismanaged, as it was over the same period of time in Russia—can spoil it too. Nonetheless, such a risk cannot be an excuse for state withdrawal from these activities. The risk calls for wise guidance and rational intervention.

In the very long term, the transition should be seen as a major instrument of development policy. Systemic changes that do not lead toward durable growth and sustainable development do not make sense. However, there are ideologically motivated efforts at change, which are made without deep concern about their pragmatic implications for society. Such motivation must not be neglected since it can be very strong, especially during a period of revolutionary change. And the postsocialist transformations are of such a nature, regardless of their pace.

Yet the situation is more complex, because behind political motivations there are always some particular interest groups. To counterbalance these interests with lobbies oriented toward long-range progress and development is not easy, since such a group would need to resist strong pressures coming from interest groups. In other words, if there are lobbies that fight with any and all means for their own present interests, there are no lobbies fighting with such determination and force in favor of long term development and remote policy targets. Actually, the only visible and somewhat effective lobby of the latter type is the environmental lobby.

However apparent it is that systemic transition is not the target but merely the path to a more important goal, there is still some confusion on this point. This confusion is first about the inter-dependence of institutional changes and real economy expansion. Can the system be perfect while growth is not satisfactory, or can it be praised at a time when ability to expand is weak? Of course it should not, yet peculiarly, it often is. It is apparent in professional discourse that reforms are appreciated for their own sake, without paying enough attention to their real outcome.

Thus the enormous contraction in Eastern Europe and the former Soviet Union has been a result of, on one hand, deficiencies of development policy and exaggeration of the significance of transition as such and, on the other, a confusion of transition with liberalization and privatization. Policies have focused mainly on stabilization measures, trade liberalization, and privatization, without paying enough attention to events in the real economy, i.e. output, consumption, investment, unemployment, etc. This approach changed the initial conditions (though not always for better) and caused contraction instead of growth.

From a very long-term viewpoint, the system's design plays an instrumental role for expansion and development. As one generation passes away, the next takes its place. When one set of solutions has ceased to serve the purpose, another must replace it and take over. Hence, the system ought to be flexible enough to meet the challenge of changing circumstances. It adjusted several times in the past and will change again many more times in the future, given its serving, i.e. supporting for development role and new, often unpredictable circumstances. Therefore, the whole transformation should be seen only as a historical episode, albeit a very important one, which may serve development needs well, if policies are managed in an appropriate way.

Contrary to this experience, attention to development policy and treatment of market-oriented reforms as the means for successful development have contributed significantly to the high rate of growth in China and Vietnam (Montes 1997). This is indeed interesting, because there is not yet any such flourishing in terms of durable growth example in postsocialist economies of Eastern Europe and the former Soviet Union. The reforms of the socialist system that failed in Europe still work in Asia. In the latter, it was feasible to distinguish between system design and policy guidance—that is, to take advantage of the system and adjust it as necessary to new challenges for the sake of further growth. This is the ability to use the system and its modification as a means of expansion, and not as a target.

Hence, within each political system there is a room for some variation, for distinct policies and exercises. The system itself cannot serve as a substitute for good policy. In history we can see most frequently that it is sufficient to improve policies, without overhauling an entire system. Of course, during transition there is also room for better or worse economic policy, for wise or not-so-wise government action, and for various forms of involvement of the international community.

7. Institution Building

We speak of building institutions, but in reality, they must be learned. This is the process. After the failure of 'shock therapy' – since it did failed -- due to the systemic vacuum and deep recession, the process of postsocialist change has been managed in a more reasonable way, by deliberate measures at a somehow slower pace. By the very nature of this long-term and complex process, it can not be carried forward in a radical way. It takes time and is costly in both financial and economic senses. It is risky and can expose the country to social and political tensions. Only part of the multi-layer transition process, namely liberalization linked with stabilization, can be executed—if political conditions permit—in a radical manner. Even this is not an imperative, but a policy choice depending on the scope of monetary and fiscal disequilibria, and on the range of social tolerance.

As for structural adjustment, institutional reform, and behavioral change, they will take a long time under any conditions. For example, in Eastern Europe it is estimated that about 77 per cent of computer software are pirated, while in the United States such malpractice stands at about 20 per cent. This is still not insignificant, but four times less common in the US than in transition economies. Such a difference cannot be explained solely on the basis of more efficient law enforcement and better marketing. The more important difference is that between a weak market culture and a mature one. Yet even in mature markets the process of behavioral change must continue if, despite the sophistication of market institutions and established market culture, as much as a fifth of computer software is still simply stolen.

Surely, from the viewpoint of the societies concerned and their political elites, it must seem that this will be a very lengthy process, but in reality it should be seen as a very short historical incident, considering the mighty and comprehensive changes that are taking place. Establishing the traditional market economies, although accomplished under different circumstances, did take much more time than the current transformations in socialist and postsocialist countries. Ten years is really a very short time to turn an economy around. So, the postsocialist transition, despite the hardship it has brought, should be seen as relatively quick process of complex changes of structures, institutions, and behaviors.

The difficulties have not derived, however, from a lack of knowledge of how the market works, but from a difficulty in knowing how to get to a market system from the specific situation of the late socialist economies. The most challenging problem is not finding a target design for new organizations and institutions, but the process of transition leading toward those targets. The most difficult question to be answered, therefore, is not how it should look and work at the very end, but how to get from here to there.

Simultaneously, a process of learning by doing is taking place. Both in the East and West previous theoretical explanations and pragmatic approaches have evolved significantly. Professionals from transition countries have gained knowledge of market performance. Great political and intellectual debates, training at home and abroad, and simple experience of the process, have brought tremendous progress vis-à-vis the qualifications of researchers, entrepreneurs, and political elites. Professionals from developed countries, including government representatives dealing with transition, experts of international organizations, and the business community has learned about the specific circumstances of transition. They have been able to absorb knowledge on various features of postsocialist realities, and have understood that one should attack the challenges in a somehow different, rather unorthodox way. Major lessons about the significance of institution building for durable growth have been learned at last, and the proper policy conclusions seem to have been drawn.

Unfortunately, the process of learning by doing has been very costly for the Eastern European and post-Soviet nations. To be sure, future growth should not be counted as compensation for the past slump. It was expected and forecast already several times that the production over the whole region will grow, yet in several cases it has happened not to be a reality so far. Worse, there are still the postsocialist economies, where output is shrinking and even further contraction, at least in the year 2000, is foreseen (table 2). As for the first 10 years of transition, GDP in postsocialist economies contracted more than at the time of the Great Depression in 1929-33. This was not necessary and could have been diminished, if actually existing knowledge about the possible alternative methods of transformation had not been neglected, and the adjustment of Western economic thought and policy advice to actual challenges had been quicker.

Later, there were better-orchestrated attempts aimed at gradual, but steady institution building. By institutions we mean not only organizations and the links between them, but also proper behavior of actors on the economic stage. Thus, with much better coordinated international assistance, transition policies have shifted in a number of countries in the right direction. Market organizations have been created, new law has been drafted and adopted, and new skills have been taught. Indeed in the late 1990s Eastern Europe, and to a lesser degree the former Soviet Union, look differently than they did in the early 1990s. Yet there is still long road to travel.

Table 2: Forecast of economic growth in transition economies, 1998-2002

	GDP index 1997 1989=100	Rate of growth 1998**	1999	2000	2001	2002	Average 1998-2002	Ranking *	GDP index 2002 1997=100	1989=100
Poland	111.8	4.8	4.5	5.0	5.4	5.7	5.6	9	128.4	**143.2**
Slovenia	99.3	4.3	3.7	4.3	4.4	4.8	4.7	15	123.4	**122.6**
Slovakia	95.6	5.3	2.2	4.0	5.6	6.9	5.3	10	126.3	**120.8**
Hungary	90.4	5.2	4.3	4.1	4.0	4.1	4.7	13	123.7	**111.8**
Albania	79.1	4.3	6.2	8.9	8.0	4.4	7.2	4	136.0	**107.6**
Uzbekistan	86.7	4.5	4.5	4.3	3.8	4.2	4.6	16	123.2	**106.8**
Czech Republic	95.8	-2.5	0.5	3.3	3.9	5.2	2.1	23	110.6	**106.0**
Estonia	77.9	6.4	6.1	5.9	6.9	5.9	7.1	5	135.3	**105.4**
Romania	82.4	-4.7	2.2	4.9	4.8	5.1	2.5	22	112.5	**92.7**
Croatia	73.3	4.2	2.9	4.3	4.1	4.3	4.3	19	121.4	**89.0**
Bulgaria	62.8	3.5	2.7	4.6	5.2	5.2	4.6	17	123.0	**77.3**
Yugoslavia	62.7	5.4	1.3	3.9	4.7	5.5	4.5	18	122.5	**76.8**
Latvia	56.8	6.6	5.4	4.4	3.9	5.4	5.7	8	128.5	**73.0**
Kyrgyzstan	58.7	3.0	3.0	4.7	5.2	5.7	4.7	14	123.5	**72.5**
Turkmenistan	48.3	4.7	12.1	16.0	3.5	4.2	9.4	2	146.8	**70.9**
Kazakhstan	58.1	1.4	0.6	3.0	5.5	8.3	4.0	20	120.0	**69.7**
FYR Macedonia	55.3	5.3	4.7	4.6	4.1	4.1	5.0	12	125.0	**69.1**
Belarus	70.8	4.2	-9.3	-5.8	1.5	2.9	-1.4	26	93.0	**65.8**
Azerbaijan	40.5	7.9	7.9	9.0	9.9	10.7	10.9	1	154.4	**62.5**
Lithuania	42.8	7.4	4.5	3.7	3.8	4.1	5.2	11	125.8	**53.8**
Armenia	41.1	5.7	4.4	5.0	5.7	6.1	6.0	6	129.9	**53.4**
Tajikistan	40.0	4.3	4.3	5.8	5.5	5.9	5.7	7	128.6	**51.4**
Russia	52.2	-4.7	-5.3	-2.6	3.9	4.1	-1.0	25	95.1	**49.6**
Georgia	34.3	7.2	5.1	7.9	9.4	8.0	8.7	3	143.6	**49.3**
Moldova	35.1	-2.2	0.7	4.1	5.2	6.2	2.9	21	114.5	**40.2**
Ukraine	38.3	-2.0	-5.2	-1.1	4.0	4.6	0.0	24	100.0	**38.3**

Sources: PlanEcon 1998a and 1998b, and author's calculations based on Table 1.

* Ranking is according to the 2002 GDP index (1997=100) and 1998-2002 average rate of growth.
** Preliminary evaluation

8. Policy Conclusions

It is true that the course of events in postsocialist economies has been under great influence from policies based upon the Washington consensus. But it is also true that the transformation to a market economy and occurrences accompanying this process have had significant impact upon the revision of these policies. On the one hand, the line of thought typical for the Washington consensus has had important meaning for the directions of systemic reform and policy attempts in Eastern Europe and the former Soviet Union. On the other hand, the fact that suggested and executed policies did not bring the expected results led to a search for alternative policy means. Actually, the range of issues upon which there is consensus among the major partners on the global financial, economic, and political scene has expanded over the years.

The postsocialist transformation has contributed to this evolution of attitudes. New issues and problems have emerged together with the emerging postsocialist markets, and hence there are new concerns, toward which views differ and are far from being agreed upon. Nevertheless, there are numerous symptoms of an urgent need for a new consensus. Additionally several new elements must be emphasized in what has been agreed upon in the past.

There are twelve major policy conclusions:

1. The main policy conclusion -- and the key implication of the post-Washington consensus -- is that the institutional arrangements are the most important factor for progress toward durable growth. What is taken for granted in some market economies, i.e. an institutional set up sufficient for far going liberalization and free market performance, must be created, often from outset, in countries moving from statist, centrally planned economies. If there is a choice between developing these institutional arrangements spontaneously (by chance) or in a way directed by the government (by design), then the latter option is more suitable in the case of postsocialist countries. Yet the governments of industrial countries and international organizations must assist several governments in these attempts. Those countries which, due to strong government commitments, were able to take care of such design are doing much better. Recovery has come sooner, growth is robust and there is the prospect of sustainable development. Those which have tried to trust that major institutional overhaul can occur by itself – that is by chance -- or have not been able to lead this complex process adequately, are lagging behind in both transition advancement and pace of growth.

2. The size of the government is less important than the quality of its policy and the manner of the changes of government size. In transition economies the issue is not just downsizing the government, but a deep restructuring of the public finance system and change of the policy targets and means. Basically, fiscal transfers should be redirected from non-competitive sectors toward institution building (including behavioral and cultural changes), investment in human capital, and hard infrastructure. Attempts to downsize the government through cuts of budgetary expenditure can cause more harm than good for launching recovery and growth. Even if small government is sometimes better than a larger one, the issue is that often it can not be downsized without causing contraction and standard of living deterioration. It must be considered that creative downsizing should occur only when the economy is on the rise, though most often the strongest attempt to do so is undertaken over a period of deep contraction.

Thus, the general problem lies in restructuring expenditures rather than cutting them for an illusion of concurrent, albeit unsustainable fiscal prudence.

3. Unlike certain liberalization measures, institution building by its nature must be a gradual process. Thus feedback between specific 'inputs' to this process and its 'output' must be monitored constantly and the policies must be adjusted and corrected. In postsocialist transition there are many uncharted waters where one should not rely on misguided analogies with experience from distorted market economies. One must consider the specific features of that type of emerging market. Therefore it is necessary to orchestrate some institution building innovation in a way previously unseen in other places. This is true first regarding privatization and development of capital markets.

4. If institutional arrangement is neglected and left to the spontaneous processes and unleashed forces of liberalized markets, then informal institutionalization fills the systemic vacuum. The negligence of government in organizing market infrastructure with active policy is causing a situation in which informal organizations and institutional links among them are taking over. Extreme cases here are vast corruption and organized crime. These are the two main maladies in countries after liberalization and privatization under weak governments. Sometimes governments are too weak because they are too large, but because they were forced to become smaller too early, that is before the infant market was able to substitute for the state. Prematurely or too extensively downsized government is not strong enough and then the market expands in the informal sector (shadow economy), while difficulties mount in the official economy. Then profits accrue to the informal sector, but the revenues fall in the official sector, with all the negative consequences for the budget and social policy. Thus the market works in a way where profits are privatized, but the loses are socialized in a politically unsustainable way.

5. In transition economies the policies must transform and streamline the judiciary system to serve the needs of market economy. This is a great challenge, since the old system of contract execution under planned allocation has ceased to exist, but a new system of contract implementation under market rules and culture has not yet matured. The establishment and development of new law—e.g. trade and tax code, capital market regulation, property rights protection, competition and anti-trust rules, banking supervision, consumer protection, environmental protection—are even more important and ought to be addressed before privatization of state assets. Creation and advancement of a legal framework for the market economy should be much higher on the agenda of international financial organizations. It must be put in front, as a more urgent and important issue than liberalization and privatization, since the latter can contribute to sound growth only if the former is secured.

6. A shift of competence and power from the central government to local governments is necessary for deregulation of the postsocialist economy. Such a shift means moving the public finance system toward decentralization, and streamlining local governments by giving them larger fiscal autonomy. Otherwise the process of weakening the central government is not matched by enhancing local governments. The joint position of both levels of government must be seen as an integrated entity needed for the sake of gradual institution building. If local governments are not enhanced while at the same time the central government is weakening too much, and market forces are not yet supported by new institutional arrangements, than liberalization and privatization will not necessarily improve capital allocation and will not raise efficiency.

7. There is an urgent necessity to accelerate the development of non-government organizations. Next to the private sector and the state, this is the third indispensable pillar of a contemporary market economy and civic society. With a lack of a range of NGOs, which are supposed to take care of various aspects of public life, there is a continued tension between the state and society, and the expanding private sector does not provide sufficient or satisfactory solution to this matter. There are spheres within the public domain that must depend neither on the state, nor on the profit-oriented private sector. A growing part of international technical, financial, and political assistance must be channeled into enhancing the NGOs. Otherwise the infant market economy and democracy in postsocialist countries will not evolve fast enough and the transition will be incomplete. The delay of institutional infrastructure provided by the NGOs becomes a growing hurdle for successful systemic changes and high-quality growth.

8. During transition income policy and government concern for equitable growth has great meaning. Whereas increasing inequity is unavoidable during the initial years of transition, the state must play an active role, through fiscal and social policies, in controlling income dispersion. There is a limit of disparity beyond which further expansion of overall economic activity becomes constrained and growth starts to slow or recovery is delayed. If disparity growth is tolerated for a number of years during contraction, when the standard of living is improving for a few and declining for many, then the political support for necessary reforms will evaporate. Hence, large inequities turn against crucial institutional and structural reforms.

9. Postsocialist transition to the market is taking place at a time of worldwide globalization, hence opening and integration with the world economy is an indispensable part of the whole endeavor. Yet these processes must be managed carefully with special attention to short-term capital flow liberalization. It must be monitored and controlled by the countries' fiscal and monetary authorities with the support of international financial institutions, e.g. the IMF and BIS. It is better to liberalize capital markets later than sooner. First the institution building must be advanced enough, and stabilization ought to be consolidated into stability. Only then should financial markets be liberalized in a gradual manner. Otherwise the societies of young emerging markets and democracies are not going to be supportive of market mechanism's introduction or integration with the world economy, and they may even become hostile toward such changes.

10. International organizations should not only support, but also insist on further regional integration and co-operation. If growth is expected to be durable and fast, it requires export expansion, which will depend on strong regional links. Thus it calls for institutional support, as export-import banks, commodity exchanges, credit insurance agencies, and suchlike. This should be the main institution building concern of the EBRD, supported by directed lending from this bank and by its technical assistance. This type of market infrastructure is still underdeveloped in transition economies, thus regional trade and cross-country foreign direct investment are lagging behind overall changes. What should be one of the driving forces of sustainable growth, is actually one of its main obstacles.

11. The Bretton Woods organizations should reconsider their policies toward transition economies. If the IMF mainly takes care of financial liquidity, currency convertibility, fiscal prudence and monetary stabilization, the World Bank should further focus attention mainly on conditions for equitable growth and sustainable development. For obvious reasons these two kinds of economic policy aims—or rather the means in the former case and the ends in the latter—are often contradictory. There is an inclination to confuse the ends with the means of the policy, to subordinate long-term development policy to short-term stabilization policy. Yet the record of transition so far has clearly proved that there is neither much development, nor stability. Hence, in the future fiscal and monetary policies must be subordinated to development policy, not the other way around. There is a need for the World Bank performance criteria describing socio-economic development as much as there is such a need for the traditional IMF fiscal and monetary criteria. The new set of criteria should always stress the implication of advised financial policies for growth, capital allocation, income distribution, and the social safety net. The World Bank should not accept and support policy reforms and actions that, while aiming at financial stabilization, may lead to social destabilization resulting from lack of growth, spreading poverty, increasing inequality, and divestment in human capital.

12. These interactive processes of learning-by-monitoring and learning-by-doing continue and will last for several years. After all, even if there is -- as indeed it seems to be -- a growing chance for some kind of the post-Washington consensus, this must be seen as a process, and not as an act. Such an emerging consensus must be accomplished indeed among many more partners than just the important organizations based in Washington. Otherwise, the policies agreed in Washington will not be able to deliver what they assume elsewhere. This is also an important policy conclusion that should be obvious in the era of globalization. Furthermore, what may be agreed upon currently, must be revised often if conditions and challenges change, as they have done recently and undoubtedly will do again and again in the future. Thus the quest for a comprehensive and implementable consensus on policies facilitating sustainable growth must continue.

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